Bennett Jones Spring 2014 Economic Outlook

Economic Growth: Moderate Pace Ahead

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Introduction

While the growth geo-political landscape has changed somewhat since our November 2013 Economic Outlook, the outlook for global economic growth has not changed much. We continue to project real global growth of about 3½% in each of 2014 and 2015. However, the international and industrial composition of that growth will change somewhat in 2014 and 2015. Growth in 2016 is projected to be about 3½% but with further changes in composition which may have important implications for Canada.

In section I, we describe the most important features of the global outlook to 2016. In section II, we present the outlook for a two-speed Canada in the context of the outlook for global growth and most importantly in the context of the ongoing structural changes in the Canadian and provincial economies. In this section, we also examine possible policy responses to the structural challenges. As usual, in the final section we examine the outlook for global trade with particular attention to the challenges we face in Canada.

Recent World Economy Dynamics

Average annual global growth for 2013 turned out marginally stronger than projected in the Bennett Jones Fall 2013 Economic Outlook (3% versus 2.9%). This small improvement largely stems from unexpectedly strong momentum of activity in the United States in the second half of the year owing in good part to temporary increases in inventory investment. Recent indicators point to [almost no U.S. expansion in the first quarter of 2014 due in large part to the transitory effect of unusually bad weather.] Canada and China also experienced faster-than-expected growth in the second half of 2013. Canadian growth accelerated largely as a result of a temporary pick-up in inventory investment. China's rate of expansion increased marginally to 7.8% during the second half of 2013, but weakened in 2014 Q1. Positive growth in the Euro area, on the other hand, lost momentum during the second half of 2013 following a timid turnaround of activity in the second quarter.

Since last November, U.S. dollar prices for WTI crude oil have firmed up by about 10 percent to US$103 in May 2014, metals and minerals have been relatively flat while forestry products on balance have declined moderately. Due to very cold weather, prices for natural gas increased sharply during the winter to reach a peak in February. By May 2014, they were still 25 percent above their very low November 2013 levels.

I Global Short-Term Outlook: 2014-2016

Overview

Although certain geo-political events (Ukraine, Thailand, India) increase uncertainty, in general developments over the last several months do not materially change the outlook for growth in 2014 and 2015 relative to our projections in the fall 2013 Economic Outlook. Our current projection calls for world economic growth in 2014 to average about 3.5% and for this faster pace to be at least maintained in 2015 and 2016 (Table 1). Most of the improved growth outlook originates in the advanced economies. Emerging markets will still grow more quickly than advanced economies, but both will grow at more similar rates in 2014-2016 than during the five years since the financial market crisis.

Advanced economies, from which much of the pick-up would originate, are likely to benefit from continued easy monetary conditions, less fiscal drag, less deleveraging, more wealth and improved confidence in the private sector.

China should experience somewhat slower growth in the next three years, partly as a result of efforts to rein in credit expansion and achieve more balanced growth. Other emerging economies would grow only moderately in the short term for several reasons including slower Chinese growth, flat to declining commodity prices, and an externally induced tightening of financial conditions. With a new government, by 2016 India may grow more quickly again.

Table 1: Short-Term Prospects for Output Growth (%)

	2013	2014	2015	2016
Canada	2.0 (1.6)	2.2 (2.1)	2.4 (2.3)	2.2
United States	1.9 (1.5)	2.5 (2.6)	3.3 (3.2)	2.7
Euro area	-0.5 (-0.3)	1.0 (1.0)	1.3 (1.3)	1.5
China	7.7 (7.6)	7.4 (7.4)	7.3 (7.3)	7.0
World	3.0 (2.9)	3.4 (3.5)	3.7 (3.6)	3.6

*Figures in brackets are from the Bennett Jones Fall 2013 Economic Outlook.

United States

In spite of negative growth in the first quarter, real GDP growth should accelerate over the remainder of 2014 to average 2.5% for the year as a whole. Annual growth should further increase in 2015 to more than 3% before slowing to a more sustainable 2.7% in 2016. This improved outlook for the remainder of 2014 and 2015 reflects several factors:

- consumption and housing investment grow strongly due to improved household employment and balance sheets,
- business investment picks up,
- fiscal policy constitutes a much smaller drag on growth than it did in 2013,
- quantitative easing continues in 2014 but at a diminishing rate, and
- the federal reserve maintains its policy rate near zero levels well into 2015.

But by 2016, the slack currently present in labour and product markets will have been largely eliminated. Thus modest increases in the policy interest rate can be expected through the year, and CPI inflation should recover to the 2 to 2 ½% range. Thus the economy is likely to grow slightly above its long term potential rate of about 2 ½%.

Other Global Economies

Europe should resume growth over the period, slowly at 1% in 2014 rising to 1 ¼% the following year and hitting 1 ½ % in 2016. The ECB may lower its policy rate in 2014 as inflation remains well below its 2% target. By 2015, growth should resume significantly in peripheral countries as the fiscal squeeze diminishes. By 2016, Europe should be growing at its long term potential of about 1 ½%. While Europe growth rates will be low by global standards over the 2014-2016 period, they will be a very significant improvement over European performance from 2011 to 2013.

Japanese growth in 2014 is likely to be weaker than the 1 ½% recorded in the last half of 2013 as tax increases reduce consumption and fiscal policy tightens. The outlook for 2015-2016 is for trend growth of slightly less than 1%.

Growth in **China**, on the other hand falls in the 7-7 ½% range over the next two years from 7.6% in 2013. Investment growth slows partly in response to excess capacity and slower credit growth. The dampening effect of the renminbi appreciation in recent years on net exports will be only partly offset by continued urbanization and a gradual firming of household consumption. Chinese authorities face a fine balance between the desire to contain credit and rebalance the economy on the one hand, and the desire to maintain adequate growth on the other hand. Growth in 2016 will depend on Chinese structural policy adjustments but could well fall below 7%.

Growth in **Brazil** and **India** should improve very modestly in 2014 and 2015 from the low levels achieved in 2013. The Brazilian projection is subject to considerable political uncertainties while the results of the recent election in India favour stronger growth.

Long Term Interest Rates

Against this outlook for growth and both monetary and fiscal policy, one would normally expect that nominal long bond interest rates (U.S. 10 year treasuries) would climb steadily from current levels (2.5%) to a more "normal" level of somewhat more than 4% by mid 2016. With inflation expectations fairly well anchored at about 2%, a 4% to 4½% 10 year treasury bond would yield an expected real return of about 2% - i.e. about the same real return that investors received from 2000 to 2007, but well below the 4% real return during the 1990s.

However, for the following reasons, we believe that there is a reasonably high probability that 10 year treasury yields will remain somewhat below 2% real, i.e. somewhat below 4% nominal, right through 2016:

- first, portfolio preferences of investors (including financial intermediaries) remain skewed toward safe assets, thus holding down the interest rates on government bonds,
- second, the shift in the global distribution of income toward capital and high income earners has increased desired saving and hence increased the supply of loanable funds,
- third, because governments are likely to continue to concentrate on reducing deficits and because cash-flush corporations remain reluctant to invest in long lived real assets, government and corporate demand for loanable funds will remain relatively weak[1].

Taking these factors into account, we project long bond rates (U.S. 10 year treasuries) to stay "low for long", i.e. below 4% (nominal) through 2016[2].

Commodities

Given the prospects for "modest" global growth over the next two years, prices of metals and minerals are likely to remain at about current levels. The trend movement in global crude oil prices is also likely to be flat (WTI at about $100 US/bbl.) but subject to volatility in the event of geopolitical disruptions. By the end of 2016, prices of natural gas in Europe and Asia could begin to weaken a little as a few LNG projects around the world begin to come on line. North American lumber prices should firm as U.S. building of single-family houses strengthens over the next two years.

Risks and Implications

Although there is now firmer evidence of a stronger momentum of activity in a number of advanced economies, our outlook for moderate 3½% growth in the global economy is, as always, somewhat uncertain. Downside risks to growth likely continue to dominate upside risks. As in the Fall 2013 Economic Outlook, the downside risks also include: (1) weaker growth in China if household consumption fails to pick up enough while investment falls relative to GDP, with adverse consequences for commodity prices and global trade; and (2) the emergence of adverse political developments in the Euro area which has still to cope with a fragmented financial system, high public debt and structural problems. But importantly for Canada, there is an upside risk to U.S. growth over the period to the end of 2016.

II. Evolution of the Canadian Economy

The Canadian economy suffered less than the American or European economy in the great recession following the 2008 global financial crisis. While both output and employment fell in 2009, by 2.7 percent and 1.6 percent respectively, by the third quarter of 2010 the level of output had regained the peak reached two years earlier and by the summer of 2010 employment had recovered to pre-recession levels. As pointed out in previous Outlook Documents, the nature of financial crisis is such that post-recession economic growth tends to be slower and bumpier than usual because of deleveraging and credit constraints. This was the case for advanced economies after 2008. Slower recovery in the other G7 economies had adverse repercussions for Canada, where growth has settled at around 2% after a marked rebound in 2010. As a result, excess capacity remained in Canada in 2013 and early 2014 although the true extent of the slack is hard to pin down. Considerable excess capacity in Central Canada clearly remains at present. However, there is evidence of excess demand in parts of the three Western provinces.

From 2014 to 2016, the outlook for Canadian GDP growth, at just over 2 percent per year, is relatively less favourable than that for the United States and much of the global economy. In this section we first quickly list the factors that contributed to the relatively superior Canadian performance through the global recession. We then present the outlook for the Canadian economy to 2016 and note some regional differences in this outlook. We finally conclude on how governments should address the structural problems which make for a bumpy road ahead for Canada.

Canadian Economic Performance: 2008-2013

The recession and slow recovery we experienced in Canada was largely imported from a weak US and global economy rather than resulting from domestic factors. Table 2 compares Canadian performance with US performance from 2007 to 2013.

Table 2: Economic Indicators: Percentage Change - Canada vs the US (US figures in Shade)

	2007	2008	2009	2010	2011	2012	2013
Real GDP	2	1.2	-2.7	3.4	2.5	1.7	2
	1.8	-0.3	-2.8	2.5	1.8	2.8	1.9
Household Consumption	4.3	2.8	0.3	3.5	2.3	1.9	2.2
	2.2	-0.4	-1.6	2	2.5	2.2	2
Residential Investment	3.4	-4.9	7.0	8.7	1.6	6.1	-0.2
	-18.8	-24	-21.2	-2.5	0.5	12.9	12.2
Business Fixed Investment	2.6	3.9	-19.6	13.7	10.0	4.9	0.7
	5.9	-0.7	15.6	2.5	7.6	7.3	2.7
Exports	1.1	-4.5	-13.1	6.9	4.7	1.5	2.1
	8.9	5.7	-9.1	11.5	7.1	3.5	2.7
Employment	2.4	1.7	-1.6	1.4	1.6	1.2	1.3
	1.1	-0.6	-4.3	-0.7	1.2	1.7	1.7
Real National Income	3.1	2.6	-6.0	4.7	3.6	1.5	2.4
	0.5	-0.5	-2.8	3.0	2.8	2.4	2.5
General Gov. Balance - % of GDP	1.6	-0.3	-4.5	-4.9	-3.7	-3.4	-3.0
	-2.7	-7.8	-14.7	-12.5	-11.0	-9.7	-7.3

Sources: Statistics Canada, US Bureau of Economic Analysis and International Monetary Fund.

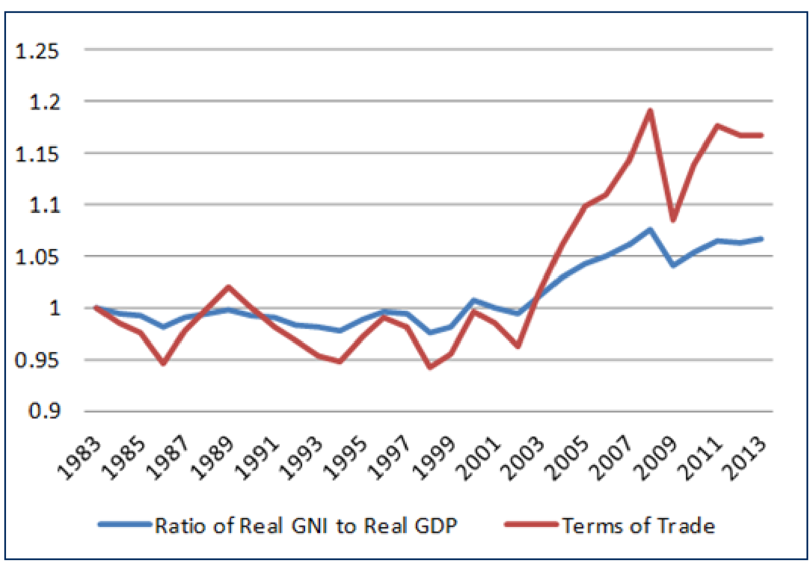
What were the factors that enabled Canada to weather the recession better than the US and our G7 counterparts?

First. Our financial system was in much better shape than those of our American, European or Japanese counterparts. Canadian banks were able to keep lending flowing to businesses (including small businesses) and households to a much greater degree than were banks elsewhere, in particular in the US and Europe. This better supply of credit helped to maintain consumption, investment and housing construction in Canada, especially in 2008 through 2011. In particular, banks were able to continue to expand mortgage finance to households which not only sustained residential investment but also underpinned rising house prices after 2009. Rising house prices helped maintain household wealth and hence consumption of other goods and services.

Second. Because the fiscal position of federal and provincial governments in Canada in 2008 was in much better shape than those of the US and most other advanced countries, Canadian governments could provide great fiscal stimulus in 2009 and 2010 without fears of our future inability to service public debt. In particular, provincial governments could maintain spending while US state governments were having to retrench from 2009 to 2012. Moreover, federal and provincial governments could embark on a path to return to fiscal balance over 2012 and 2013 without exerting the same degree of fiscal drag as was the case in the United States and most European countries.

Third. From 2008 to 2012 (except for 2009), Canada benefitted from favourable terms of trade as most commodity prices remained elevated, even though slightly below pre-recession peaks. As implied by the ratio of real gross national income (GNI) to real GDP in Chart 1, due to these favourable terms of trade real national income remained high relative to domestic production. This helped support real domestic spending. The impact differed considerably across regions of Canada, however. Rough estimates reveal that real domestic income would have climbed to the highest levels in the oil-producing provinces. Relative to the 1983-2003 period of relatively flat ratio of real GNI to real GDP for Canada (see Chart 1), over the period 2008-2012 the ratio of real domestic income was higher by 21% in Alberta, 4% in Quebec, 3% in British Columbia, and a shade lower in Ontario. However, Ontario would have drawn indirect benefits from larger exports of goods and services to the rest of Canada than otherwise.

Chart 1: Terms of Trade and Real National Income: Canada Indexes 1983=1.0



Source: Statistics Canada

At the same time as they were buttressing real national income and domestic spending, the high commodity prices and terms of trade contributed to keep the Canadian dollar strong, thereby holding down real net exports. The resulting negative impact on real GDP would have varied considerably across provinces. With its high ratio of international exports to GDP and high sensitivity of output to exchange rate compared to other provinces, Ontario likely experienced relatively more severe losses of output than other regions of Canada as a direct result of losses in exports abroad following the appreciation of the Canadian dollar.

Thus, for Canada as a whole, the likely net impact of the elevated commodity prices and terms of trade on real output was positive although highly concentrated in commodity-producing Western Canada and Newfoundland and Labrador. The net impact of the terms of trade on real domestic income, on the other hand, we estimate to have been positive for most provinces but not for Ontario.

Because these three factors allowed Canada to maintain a comparatively firm final domestic demand from 2008 to 2012, Canada did not have to undergo some of the wrenching structural adjustments which took place during 2008-2013 in the US and many European countries. While this relative lack of adjustment clearly helped to preserve Canadian employment, especially from 2008 to 2011, it was not without negative consequences for the future. It contributed to weaker productivity growth and faster compensation increases in Canada than in the US, which in turn resulted in a much stronger increase in Canadian unit labour costs than in the US (Table 3). Factoring in the effect of an average 0.7 percent per year appreciation of the Canadian dollar, Canada's average loss of labour cost competitiveness amounted to 2.7 percentage points per year relative to the US from 2008 to 2013.

Table 3: Average Annual Growth Rates: 2008-2013

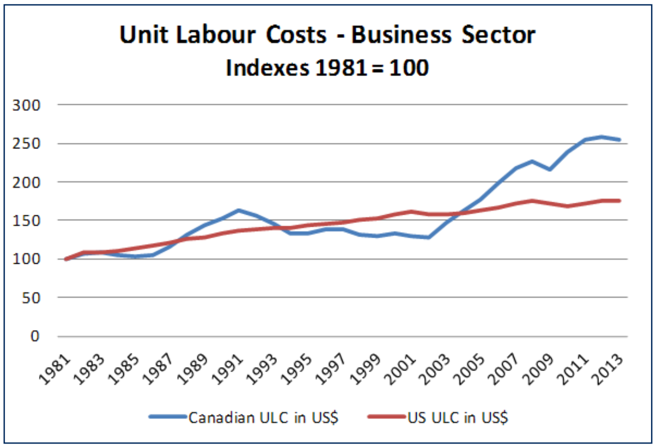
	Business Sector	
	Canada	United States
Labour Productivity	0.5	1.7
Hourly Compensation (in domestic currency)	2.6	2.1
Unit Labour Costs (in domestic currency)	2.0	0.4
Appreciation of the C$/US$	0.7	
Unit Labour Costs (in US$)	2.7	0.4

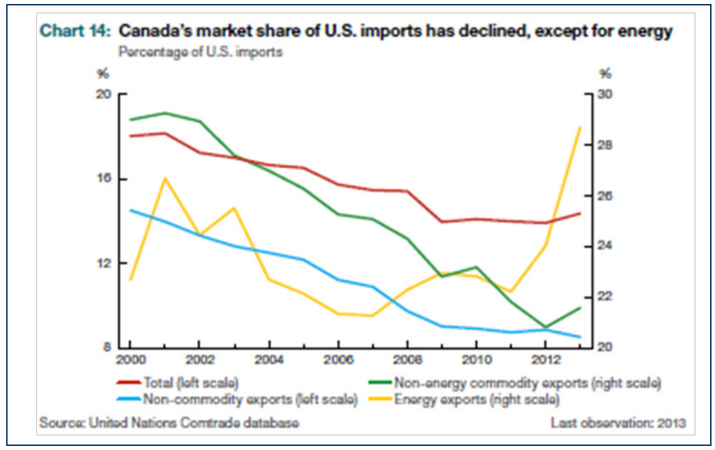
Sources: Statistics Canada.

The loss of Canadian labour cost competitiveness over the last six years is the prolongation of a movement that steadily built up starting in 2004 (Chart 2). Over the preceding 20 years, a trend depreciation of the Canadian dollar had tended to offset a chronic shortfall of labour productivity growth in Canada relative to the US, thereby limiting the divergence in Canadian and US unit labour costs in US dollars. After 2003, however, the appreciation of the Canadian dollar (except in 2009) compounded the loss of Canadian competitiveness with respect to labour productivity and labour compensation. Even with the roughly 10% depreciation of the Canadian dollar since January 2013, the cumulative loss of cost competitiveness since 2003 remains exceptionally large by historical standards. This is a serious issue for a wide range of industries exposed to international competition. In Central Canada the decline in competitiveness means further losses of jobs notably in manufacturing and those service industries which are exposed to some degree of international competition. In Western Canada, it means that commodity producers become more vulnerable to any commodity price decline because of their relatively high costs in US dollars.

Chart 2: : Save this space

It is unreasonable to expect that Canada would maintain or increase its share of world exports given the rapid growth rates in the developing world. However, as shown by Chart 14 from the Bank of Canada, to lose market share of US non-energy imports so dramatically in the last decade or so raises questions about Canada's capacity to prosper in global markets without substantial improvements in Canadian competitiveness.





Source: Bank of Canada, Monetary Policy Report, April 2014, p. 14.

Short-Term Outlook

In the preceding section we traced the evolution of the Canadian economy from the start of the recession to 2013. In this section we examine the prospects for growth from 2014 to 2016.

Canadian growth accelerates moderately from 2.0 percent in 2013 to 2.2 percent in 2014, 2.4 percent in 2015 and 2.2 percent in 2016 mainly on account of some strengthening in business fixed investment and exports as global growth improves and confidence rises (Table1). In particular, faster projected growth in U.S. industrial production is expected to support demand for Canadian exports of raw materials and semi-finished products. The lack of cost competitiveness, however, is projected to restrain the rate of growth of exports as well as slowing business investment, including in the energy sector. This lack of competitiveness underscores the need for more structural adjustment (and greater investment in infrastructure) in order to secure more growth in productivity and output. At the same time, the high level of household indebtedness and rising mortgage interest rates are expected to dampen growth in household spending.

However, the federal government will no longer exert fiscal drag on the economy in 2015 and 2016 as federal revenues and expenditures are expected to be kept in rough balance.

With projected rates of real GDP growth not much faster than the expected potential output growth rates of about 2 per cent over the next two years, slack in the Canadian economy as a whole would diminish only gradually. The economy would remain in a state of excess supply until late in 2015, with the residual slack concentrated in Central Canada and the maritime provinces. Western Canada, on the other hand, already shows signs of incipient excess demand. Nationally, although rising progressively, core inflation would likely remain below or only slightly above the 2 per cent target to the end of 2015. Pressure to begin raising the overnight policy rate would not likely be felt before mid-2015. Slow gradual increases in the policy rate are expected to begin in the second half of 2015 and continue in 2016.

Last fall, when the Canadian dollar was around US$0.96, the relatively weak cost competitiveness and slow absorption of excess supply that we projected for Canada led us to anticipate some weakening of the Canadian dollar within a US$0.91-$0.98 range in the near term. We now expect some further trend decline in the Canadian dollar, which will likely trade in a range of US$0.87-$0.94 in the near term. Note also that if the Federal Reserve were to raise US interest rates more rapidly than is currently projected, this would temporarily reinforce our projected trend decline in the Canadian dollar. This trend decline would contribute to some strengthening of net export volumes in the longer run and could stimulate investment in new capacity if the lower range was expected to persist for a prolonged period. This being said, cost competitiveness would remain far from strong by historical standards especially since prospects for large improvements in unit costs through faster productivity growth or slower compensation increases appear highly unlikely over the next two years.

The overall scenario for Canada masks appreciable differences in economic performances and structural problems across regions. In fact, Canada will continue to be a two-speed economy. In view of their industry mix, the rate of output growth in Ontario, and to a lesser extent in Quebec, is particularly sensitive to changes in relative cost competitiveness. Unless the Canadian dollar adjusts significantly down from recent levels, Ontario and Quebec face more downside risks to growth from lack of competitiveness than the rest of Canada generally. Oil-producing provinces, on the other hand, will likely experience more growth and more wage and cost increases than the rest of Canada. These provinces remain all the more vulnerable to commodity price declines because they too have experienced a loss of cost competitiveness.

Some Policy Implications

After having looked at how the global and Canadian economies are likely to unfold in the next few years and in light of the previous discussion of the structural factors acting on the Canadian economy, we outline in this section some policies that Canada should follow to promote stronger economic growth.

As previously discussed, three factors helped support the Canadian economy in the wake of the financial crisis: a relatively sound financial system, a relatively solid fiscal position at the outset of the crisis, and favourable terms of trade. However, Canada's loss of cost competitiveness since 2007 has been exceptionally large. This unit cost factor has negative implications for growth in the years ahead. How should policies cope with these four factors?

First, with respect to the Canadian financial system, in order to support growth it is important to maintain financial efficiency and stability. Policies are being implemented that should buttress financial stability (e.g. higher capital ratios and liquidity provisions for banks). However, since 2008 the shift from "supervision" based on discussion between OSFI and the financial institutions to "regulation" based on a set of highly detailed rules will increase deadweight compliance costs and hence raise the cost of financial services in the years ahead. While Canada still has a fairly efficient financial system relative to other advanced economies, our advantage is declining. Canadian authorities should resist pressure from the Basel Committee and the Financial Stability Board to replace our highly successful pre-2008 supervisory process with costly detailed "black letter" regulation, regulation which is often not even appropriate for Canada.[3]

Second, with respect to their fiscal position, governments should expand their investment in infrastructure while restraining growth in their operating expenditures so as to gradually reduce their public debt-to-GDP ratio. With expected interest rates on new and refinanced debt remaining relatively low for years to come, reducing the debt-to-GDP ratio does not necessarily require that budgets be brought into balance precipitously. Indeed, the debt-to-GDP ratio will decline as long as the fiscal deficit as a percentage of GDP is less than the rate of nominal GDP growth, provided the interest rate on new and rolled-over debt does not exceed [by much] the rate of nominal GDP growth. It is thus important to realize that in the current environment of low long-term interest rates, fiscal prudence does not require bringing the annual budget balance to zero immediately. Small deficits (i.e. small increases in borrowing requirements to finance infrastructure investment) would still lead to declines in the debt-to-GDP ratio. Moreover, with low interest rates, it is the right time for governments and the private sector to invest in infrastructure, as explained later.

Third, with respect to Canadian terms of trade, there is little that governments can do to influence international commodity prices, which are expected to be relatively stable, if not slightly declining, over the near term. Monetary policy should continue to be oriented to maintaining core inflation at close to 2% over the medium term and not to offsetting the impact of changing commodity prices on the exchange rate.

Government policies, however, should be oriented toward helping to improve a very low level of Canadian cost competitiveness, which is the fourth factor that influences Canadian growth relative to US growth in our analysis. In fact, structural adjustment is needed not only to improve cost competitiveness so as to eliminate slack in the economy more rapidly but also to lift potential output growth from its current modest 2% rate, which would constrain economic growth once the economy reaches full capacity. This structural adjustment is needed for two purposes: (1) to raise the ratio of employment to population, which would mitigate the adverse effect of population aging, and most importantly (2) to raise the trend rate of productivity growth, which would tend to improve cost competitiveness at the same time.

a) Raising the ratio of employment to population

Population aging will slow potential output growth by reducing the growth rate of the labour force as the proportion of older workers with a relatively low participation rate in the labour force increases over time[4]. Population aging will also contribute to a decline in the proportion of the working-age population in the total population. The projected declines in both the labour force participation rate and the ratio of working-age population to total population result in a projected decline in the ratio of employment to population, and hence a decline in potential growth.

In order to offset this decline in the ratio of employment to population, policies are needed to encourage a higher rate of labour force participation for the 55-70 age groups, to facilitate labour mobility across regions, firms and industries, thereby reducing structural unemployment, and to facilitate immigration of younger workers to fill vacancies and raise the ratio of working-age population to total population.

b) Raising productivity growth

Raising productivity growth is a major challenge for businesses and governments. As shown in Table 3, average labour productivity growth in Canada was only half as much as in the US over 1997-2010. In comparison with the US, Canada invests slightly less in physical and intellectual capital per worker (slower growth in capital intensity) but, more importantly, innovate much less and more generally combines labour and capital less efficiently over time to produce output – which is reflected in a virtual lack of "multifactor" productivity growth in the business sector. This is only slightly offset by a more favorable evolution of the labour composition in Canada in terms of education and experience.

Table 4: Labour Productivity Growth by Source: 1997 to 2010 Business Sector

Average Annual Growth (%)	US	Canada
Labour Productivity	2.74	1.38
Sources of Growth in Labour Productivity:		
Contribution of Capital Intensity	1.21	1.05
Contribution of Labour Composition	0.27	0.32
Multifactor Productivity	1.24	0.02

Sources: Statistics Canada.

Governments have intervened in several ways in the past to stimulate productivity growth in the business sector, but with very limited success apparently. This is not the place to review all these programs and make detailed suggestions. Instead, we outline a few areas of policy action for governments. An important initiative would be to intensify investment in infrastructure – ports, roads, transit systems…This would enhance multifactor productivity growth and cost competitiveness in the business sector and open up new markets for Canadian exports. This is the right time to invest in infrastructure for both governments and businesses, not only because of our structural problems but also in view of the prevailing low real interest rates. Such investment could be financed directly by governments through borrowing in capital markets or indirectly through Public-Private Partnerships. Moreover, infrastructure bonds would provide suitable long-term assets for pension plans and insurance companies to match their long-term liabilities.

Three other areas of government intervention to foster productivity growth are: (1) implementing smart, efficient regulation that minimizes deadweight administrative costs for firms; (2) increasing investment in human capital development, especially in collaboration with employers through employees learning new skills on the job; and (3) fostering greater competition in markets for goods and services through external pressures from lower tariffs and non-tariff barriers brought about by new trade agreements.

III. Trade Developments

Whether and on what scale structural adjustment will take place in Canada are uncertain. To translate the higher potential growth and improved competitiveness that would result from it into higher actual growth in output and employment, it is important that firms have access to international markets for goods and services. This section discusses where things stand with respect to international trade arrangements and negotiations.

Efforts by all the major trading countries to secure more liberal access to the world's most attractive markets have resulted in a network of overlapping negotiations aimed at creating free trade agreements. This process has been called competitive trade liberalization. The stakes are high because the first country to secure improved access to a particular market can score major advances over its competitors particularly if the original barriers had a real trade restrictive effect. Competitive trade liberalization creates a very different environment for business than the one that existed under a global trading system of uniform multilateral rules largely shaped by the GATT and the WTO. Previously with the exception of a few free trade agreements virtually all suppliers faced exactly the same tariff barriers in key markets. Now with new agreements with different content being negotiated and implemented in different time frames the environment in which companies are operating is much more complicated. In this process of negotiations there have been some achievements in the last half year but there are also some question marks about whether Canada and other countries will be able to sustain the ambitious program of trade negotiations that characterized much of 2013.

WTO

Governments of the some 160 Members of the World Trade Organization (WTO) successfully concluded their ministerial conference last December in Bali. Most significantly they reached agreement on a Trade Facilitation Agreement that the International Chamber of Commerce claims could "could reduce total trade costs by 10% in advanced economies and by 13-15.5% in developing economies". The Chamber also states that, "It is estimated that the agreement could increase exports of developing countries by approximately US$570 billion and exports of developed countries by US$475 billion." While the overall outcome of the conference was modest the potential impact of this agreement once implemented will be helpful to Canadian exporters.

Ambitious Canadian Trade Negotiations Agenda

The Harper Government's ambitious trade negotiations agenda scored a success in March with the conclusion of a free trade agreement between South Korea and Canada. There is a good prospect that his agreement could be brought into force as early as January 1 of next year.

Progress has been less good in completing negotiation of the Comprehensive Economic and Trade Agreement (CETA) with the EU. Prime Minister Harper and EU Commission President Barroso announced an agreement in principle in October but 7 months later the two sides have so far been unable to iron out the remaining differences. The CETA is the flagship of the Government's trade initiatives and the failure to bring negotiations to a conclusion is disturbing.

Once agreement is reached between Canada and the EU it will take about 2 years to take the steps necessary to bring it into force. First the text, like that of all treaties, will need to be legally "scrubbed". Second the agreement will need to be translated into French and the other 22 official languages of the EU and those different versions will need to be legally verified. Third the agreement will need to be ratified and the necessary changes to legislation made. In Canada this will require action by the Parliament of Canada and by the provinces. In the EU the agreement will need approval by the Council or Ministers (representing the governments of the Member States) and the European Parliament at which point it could be brought into force provisionally. Subsequently it will almost certainly be necessary for the agreement to be ratified by the parliaments of the 28 Member States. Thus any positive benefits for Canadian industry will only begin to occur after 2016.

The Canadian government is pursuing many other initiatives including a potentially very significant negotiation with Japan to conclude an economic partnership agreement.

In addition the Government is engaged in efforts to remove persistent barriers impeding the conduct of business with our largest trading partner the United States by advancing the Beyond the Border Action Plan and the work of the Regulatory Cooperation Council. Some useful progress has been made but much remains to be done.

There are also new opportunities to strengthen economic opportunities among the three North American countries. Under the administration of President Peña Nieto Mexico has undertaken significant economic reforms. These reforms and particularly the energy reforms offer major new opportunities for Canada to strengthen the important economic relationship that has already developed under NAFTA. Canadian firms in the oil and gas service industry will find promising possibilities to work with Mexican firms in modernizing the Mexico's energy sector. The North American Leaders Summit has already addressed the value of strengthening North American cooperation. The next Summit will be hosted by Prime Minister Harper in 2015. That is an opportunity for Canada to take a leadership role in reinvigorating the North American partnership. But to play that role effectively Mr Harper must act now to resolve the current issues with Mexico including the visa issue.

Mega-Regional Negotiations

The so-called mega-regional negotiations are an important part of the trade negotiations landscape, notably the Trans-Pacific Partnership Negotiations (TPP) with 12 participants including the United States, Japan and Canada, and the TransAtlantic Trade, and Investment Partnership (T-TIP) negotiations between the United States and the European Union. Making progress in both these negotiations has been made more difficult because of the failure of the United States Congress to grant "trade promotion" or "fast track" negotiating authority to the Obama administration. The lack of authority makes partners of the US reluctant to put difficult concessions on the table when they don't know whether the US will be able to get Congress to approve what the administration negotiates. While there is clear political commitment to complete both these negotiations, the time frames originally envisaged have slipped and will probably slip further with upcoming elections in both the EU and the US making progress on difficult issues problematic.

Both of these negotiations have implications for Canada. The successful conclusion of the TPP negotiations would benefit Canada through new market access opportunities in Japan and other significant players in South East Asia. In addition it could well result in some valuable improvements to the 20 year old NAFTA agreement. On the other hand if the TPP slows down it may give Canada an opportunity to complete bilateral negotiations with Japan and offer Canadian producers the prospect of getting preferential access to that market ahead of their American competitors.

The T-TIP negotiations and the results of the recent European elections may complicate EU efforts to ratify the CETA agreement with Canada as members of the European Parliament consider how the agreement with Canada may act as a precedent for the much more important European deal with the US.

As the year progresses there will be a lot to monitor in this complex and challenging environment of competitive trade liberalization. But in general 2014, like 2013, risks being a year of talk but little action.

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1. See the World Economic Outlook, IMF April 2014, Chapter 3 for an historical perspective on real interest rates.
2. This being said, there is a small probability that long bond rates increase well above 4% if monetary authorities were to become so concerned about excessive systemic risk in the shadow banking system that in order to preserve financial stability they would raise their policy rates more than warranted by prospects for growth and inflation.
3. For a recent discussion of financial sector regulation, see David A. Dodge, "Re-Awakening Market Efficiency and Growth in the Financial Sector", February 2014. To be found in http://www.bennettjones.com/dodgedavid/
4. For a discussion of the effect of population aging on the aggregate labour force participation rate for Canada, see David A. Dodge and Richard Dion, "Macroeconomic Aspects of Retirement Savings", Bennett Jones, April 2014.

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